

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:NEW:TL-N-2792-00
CConnell

date: April 6, 2001

to: Territory Manager Marilyn Walter, LMSB

from: Associate Area Counsel, LMSB, Newark

subject: [REDACTED] - Royalty Strip ([REDACTED] Partnership)

This memorandum responds to your oral request for assistance. This memorandum should not be cited as precedent.

Issue

Whether the disallowance of a royalty payment to a partnership, in which the taxpayer's subsidiary is a partner, is a partnership item or affected item, requiring the issuance of an FPAA?

Statement of the Facts

The audit of [REDACTED] ("[REDACTED]") and [REDACTED] ("[REDACTED]") has not been completed. Based upon a preliminary review of the information the taxpayer supplied, we understand the following facts to be true. As additional information is developed, these facts may change and our opinion could also change.

This case involves a "royalty strip tax shelter." The shelter runs from [REDACTED] - [REDACTED]. [REDACTED] contributed its fully amortized patents in [REDACTED] and [REDACTED] to [REDACTED] ("[REDACTED]"), a [REDACTED]% subsidiary of [REDACTED]. At the same time, [REDACTED] also contributed its stock interests in [REDACTED], a [REDACTED]% subsidiary that was essentially a corporate shell, to [REDACTED]. [REDACTED] then contributed both the patents and the stock in [REDACTED] to [REDACTED] for a partnership interest. [REDACTED] ("[REDACTED]"), an English bank, also obtained a partnership interest for \$[REDACTED] in cash. [REDACTED] made and deducted royalty payments of approximately \$[REDACTED] per year to the partnership for use of the [REDACTED] and [REDACTED] patents.

For tax purposes, the taxable income of the partnership

(consisting mostly of [REDACTED]'s royalty payments) is allocated largely to [REDACTED]. This results because no amortization is allowed on the patents, and thus, there are relatively few expenses to offset the [REDACTED] royalty payments. Through convoluted formulas, the bulk of the partnership taxable income is allocated to [REDACTED]. [REDACTED] asserts that it does not have a permanent establishment in the U.S. and pays no U.S. taxes. On its English tax return, [REDACTED] only declares its actual net cash profit from the [REDACTED] transactions.

In contrast to the taxable income, [REDACTED] actually receives a much smaller percentage of the cash flow. Essentially, through convoluted preferential return provisions, [REDACTED] will receive a cash return equal to its normal lending rate plus [REDACTED] basis points. This occurs because for determining cash flow allocations, the net cash profit is reduced to account for the value of the patents (while no deduction is allowed for tax purposes). Thus, the cash flow to be allocated is much smaller than the taxable income to be allocated.

The cash that represents the difference between the taxable income allocated to [REDACTED] and the cash distributions allocated to [REDACTED] is transferred to [REDACTED] for investment. [REDACTED] invested these funds in [REDACTED] short-term debt. Therefore, this sheltered income circles back to [REDACTED].

We have not analyzed [REDACTED]'s exit strategy in any detail. Essentially, sometime in [REDACTED] [REDACTED] was to borrow funds from [REDACTED] to distribute [REDACTED] its \$[REDACTED] original investment. [REDACTED] would then distribute its stock in [REDACTED] to [REDACTED]. Apparently, although the bulk of assets of [REDACTED] were financial instruments, [REDACTED] intends to argue that the stock in [REDACTED] is not a marketable security under I.R.C. § 731(c) and the distribution is tax free under I.R.C. § 731(a)(1).

The statute on [REDACTED]'s Form 1065 and [REDACTED] expired for the years [REDACTED]-[REDACTED]. However, the statute for [REDACTED]'s corporate returns for these years remains open pursuant to extension.

Advice

In the present case, the statute of limitations period under I.R.C. § 6229 for assessing tax attributable to a partnership or affected items has expired. Further, while [REDACTED] signed Forms 872 for its corporate return for the years [REDACTED] to [REDACTED], these Forms 872 did not expressly provide that they applied to partnership items. Thus, the statute of limitations on [REDACTED]'s corporate tax return is not extended under I.R.C. § 6501(c)(4) with respect to partnership or affected items. See Rhone-Poulenc Surfactants And Specialties, L.P., v. Commissioner, 114 T.C. 533 (2000). Accordingly, the Service may not presently adjust

partnership or affected items with respect to [REDACTED] for the years [REDACTED]-[REDACTED].

While some of the arguments we may have raised concerning this shelter are partnership items¹, [REDACTED] claimed a deduction for the royalty payment from [REDACTED] to [REDACTED] on [REDACTED]'s tax return. This deduction may be attacked under various arguments, including, but not limited to, that the payment was not ordinary and necessary under I.R.C. § 162, that in substance the payment was not a royalty payment because the payment simply circled back to [REDACTED], and that the payment was excessive under I.R.C. § 482. As explained below, the issues related to whether this royalty payment is deductible are not partnership items or affected items requiring the issuance of an FPAA. Accordingly, we recommend that you continue to develop these issues as the statute of limitations on [REDACTED]'s corporate return is still open.

Treas. Reg. § 301.6231(a)(3)-1 provides:

(a) In general. For purposes of subtitle F of the Internal Revenue Code of 1954, the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items:

. . . .

(4) Items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner:

(i) Contributions to the partnership;

¹For example, one could argue that the allocation of a substantial part of the taxable income to [REDACTED], where [REDACTED] receives a much smaller percentage of the cash flow, lacks economic substance. The Service could adjust the partnership's allocation of taxable income to the partners to more accurately reflect the substance of what occurred. Such adjustments would be considered a partnership items.

- (ii) Distributions from the partnership; and
- (iii) Transactions to which section 707(a) applies (including the application of section 707(b)).

With respect to I.R.C. § 707, this section provides:

Sec. 707. Transactions between partner and partnership.

(a) Partner not acting in capacity as partner.

(1) In general. If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

All of the transactions listed above are between a partnership and a partner, not third parties. Thus, the issue of whether [REDACTED] may deduct the royalty payment to [REDACTED] is not a partnership item or affected item under Treas. Reg. § 301.6231(a)(3)-1 because [REDACTED] is not a partner in [REDACTED], its subsidiary [REDACTED] is the partner. Accordingly, we recommend that you continue to develop issues related to the deductibility of this payment including, but not limited to, that the payment was not ordinary and necessary under I.R.C. § 162, that in substance the payment was not a royalty payment because the payment simply circled back to [REDACTED], and that the payment was excessive under I.R.C. § 482.

In reaching this conclusion, we recognize that in order to prevail on these issues, the Service would have to present the factual background of the partnership, including the facts that the taxable income was allocated differently from the cash flows and that the money actually circled back to [REDACTED]. We view this evidence as simply relevant to determining the substance of [REDACTED]'s payment to [REDACTED]. Since [REDACTED] was not a partner in [REDACTED], the fact that this evidence is relevant to these issues does not convert these issues to partnership items.

Hazards of Litigation and Case Development

(b)(7)a [REDACTED]

(b)(7)a [REDACTED]

Under I.R.C. § 6231, a partner includes "any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." [REDACTED] filed a consolidated return with [REDACTED] and [REDACTED] declared partnership items from [REDACTED]. (b)(7)a

(b)(7)a

(b)(7)a

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(b)(7)a

(b)(7)a

(b)(7)a

(b)(7)a

In [REDACTED], [REDACTED] planned to pay [REDACTED] back its \$ [REDACTED] investment and distribute the stock in [REDACTED] (where the bulk of the sheltered income would be maintained) to [REDACTED]. [REDACTED] apparently contends that the distribution of stock in [REDACTED] in [REDACTED] is not taxable under I.R.C. § 731.

(b)(7)a

(b)(7)a

I.R.C. § 736 treats liquidating distributions as distributions under I.R.C. § 731. I.R.C. § 731 states that a partner receives gain on a distribution only to the extent the "money" received in the distribution exceeds the partner's basis in the partnership. However, I.R.C. § 731(c) treats marketable securities as "money" for purposes of determining gain under I.R.C. 731(a).

I.R.C. § 731(c)(2)(B)(v) states that an interest in any entity is a marketable security if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both. Under Treas. Reg. § 1.731-2 (c)(3)(i) "substantially all of the assets" means 90% or more of the assets by value.

Further, if more than 20% of the assets of the entity by value are marketable securities, then a portion of the value of the interest in the entity is considered a marketable security. This amount is computed by multiplying the value of the entity times the percentage of the assets of the entity (by value) that represent marketable securities. Treas. Reg. § 1.731-2(c)(3)(ii).

(b)(7)a

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DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions concerning this matter, please contact Craig Connell, Esq. At 973-645-2592.

JOSEPH F. MASELLI
Area Counsel
(Heavy Manufacturing, Construction
and Transportation:Edison)

By: _____
WILLIAM F. HALLEY
Associate Area Counsel
(Large and Mid-Size Business)

Attachments

cc: Team Manager Patrick Kelly